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Before the
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Institutional Cost Contribution
Requirement for Competitive Products

Docket No. RM2017-1

PUBLIC REPRESENTATIVE REPLY COMMENTS IN RESPONSE TO
ADVANCE NOTICE OF RULEMAKING

(March 9, 2017)

## I. INTRODUCTION

On November 22, 2016, the Commission issued an Advance Notice of Proposed Rulemaking in this proceeding to evaluate the Postal Service's required institutional cost contribution for competitive products.[1] The Public Representative's Comments presented arguments why the Commission should retain its current 5.5 percent competitive product institutional cost contribution requirement.[2] These Reply Comments respond to arguments presented by United Parcel Service (UPS) that contend the Commission should increase the contribution requirement significantly.[3]

This rulemaking was initiated pursuant to the requirement of 39 U.S.C. § 3633(b), that every five years the Commission shall review **"**the institutional costs contribution requirement under subsection (a)(3) of section 3633.**"** Subsection (a)(3) requires the Commission to "ensure that all competitive products collectively what the Commission determines to be an appropriate share of institutional costs." Pursuant to section 3633(b), the Commission must consider whether the appropriate share specified in the

[1] Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, November 22, 2016 (Order No. 3624).

[2] Public Representative Comments in Response to Advance Notice of Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, January 23, 2017.

[3] Other commenters, primarily Amazon Fulfillment Services, Inc., would eliminate the requirement entirely by reducing it to zero percent contribution.

Commission's regulations "should be retained in its current form, modified or eliminated." To carry out the evaluation, section 3633(b) prescribes that "the Commission shall consider all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products." The Commission is to review whether the appropriate share of the institutional cost contribution requirement to be collected from competitive products collectively "under subsection 3633(a)(3) should be retained in its *current form, modified, or eliminated*." (Emphasis supplied.) 39 U.S.C. § 3633(b).

These Reply Comments in response to UPS's initial comments, emphasize several more general points the Commission should keep in mind when reaching its determination about the appropriate level of contribution from competitive products.

## II. REPLY COMMENTS

### A. POSTAL SERVICE MARKETING CLAIMS DO NOT INDICATE UNFAIR COMPETITION BY THE POSTAL SERVICE.

In its initial comments, UPS attempts to cast doubt on the existence of "fair competition" on the part of the Postal Service. UPS states that in comparison to the Commission's characterization of the Postal Service as having a "relatively small" market share in 2007, "Today, a decade later, the Postal Service proclaims that it delivers 'more e-commerce packages to the home than any other shipper' or 'than anyone else in the country,' and is responsible for *delivering* 'one-third of all domestic packages in the United States.'" UPS Comments at 2 (footnotes omitted). This is an apparent attempt to portray the Postal Service as a dominant player in the parcel delivery market presumably as a result of unfair competition. However, UPS omits certain relevant facts.

First, while the Postal Service could indeed be delivering one-third of all domestic packages in the United States, that does not account for the fact that many of these packages originate with either UPS or FedEx as part of their Surepost and Smartpost programs, respectively. Presumably, UPS does not contend the Postal Service competes unfairly by charging UPS and FedEx too little for those services.

Second, the broader parcel delivery market consists of more than just the e-commerce market where UPS and FedEx primarily compete with the Postal Service. There is also the Business-to-Business (B2B) market which features higher delivery density and is thus more lucrative and, apparently, much larger than the Business-to-Consumer (B2C) market. That segment of the market is dominated by UPS and FedEx; effectively a duopoly.[4] This fact is often obscured due to the fact that e-commerce has exhibited a faster rate of growth and certainly dominates the business news headlines. Nonetheless, UPS is a dominant player in the B2B market, and certainly a significant player in the e-commerce market. For 2016, Business-to-Consumer (B2C) traffic, almost all of it originating from some form of digital commerce, accounted for 48 percent of UPS' total traffic. *Id*. UPS is thus hardly an apparent victim of unfair Postal Service competition.

UPS attempts to justify its position that, because the Postal Service is engaging in unfair competition by underpricing its competitive product services, the Commission should require an increase in the Postal Service's minimum contribution from its competitive products as being in the public interest. UPS Comments at 4. Similarly, it has been reported that FedEx believes retailers should be paying more for "web delivery."[5] The Public Representative as well as 65 million Amazon Prime members,[6] millions of E-Bay users and more than a few Walmart customers would probably dispute that notion.

[4] "For UPS, e-commerce has become the tail that wags the big dog," Mark B. Solomon, www.dcvelocity.com, January 31, 2017.

[5] "FedEx Says Retailers Should Be Paying More for Web Delivery" Laura Stevens, *Wall St. Journal*, March 17, 2016.

[6] "Amazon just shared new numbers that give a clue about how many Prime members it has", Eugene Kim, Business Insider.com, February 13, 2017.

### B. THE POSTAL SERVICE CANNOT USE ITS MONOPOLY POSITION TO CONTROL THE COMPETITIVE PRODUCT MARKET WHICH IS IN A STATE OF FLUX AND THE COMMISSION SHOULD STRIKE A BALANCE BETWEEN MAILERS AND COMPETITORS.

UPS attempts to employ fear tactics in its effort to persuade the Commission to take action which most likely would force the Postal Service to raise its competitive products' prices significantly. UPS points to the comments of Amazon's consultant, Professor John Panzar, purportedly explaining how the Postal Service's ability to exploit the cost advantages arising from the postal monopoly could naturally lead to a "monopoly industry configuration" where the Postal Service becomes the sole provider of competitive products and services. UPS Comments at 25. While this might be possible when Dr. Panzar's models are extrapolated to their theoretical limits, it is highly unlikely in actuality. The Postal Service is far from becoming the sole provider of competitive products and services. For example, during the peak holiday season, no shipper appears to have had much excess capacity, let alone enough excess capacity to absorb a significant portion of another shipper's business.[7]

The retailing industry and the e-commerce value chain are in a state of flux. On February 7, 2017, FedEx announced the launch of a new service that would compete with Amazon's fulfillment service.[8] Another major player in the retailing industry, Wal-Mart, recently announced a new program designed to more aggressively compete in e-commerce. In making its announcement, its president and CEO indicated that, "In this day and age, two-day shipping is really just 'table stakes'. We don't think it's necessary to charge a membership for it."[9] The shipping companies do not enjoy being the "tail"

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[7] "UPS, FedEx Struggle to Keep up with Surge in Holiday Orders," Erica E. Phillips and Jennifer Smith, *Wall St. Journal,* December.13, 2016.

[8] "FedEx Just Launched a New Service that Takes on Amazon's Super Popular Fulfillment Program," Eugene Kim, *Business Insider*, February 7, 2017.

[9] "Wal-Mart Scraps Amazon Prime Competitor in Favor of New Free Shipping Tactic" cnbc.com, January 30, 2017.

wagged by the e-tailing "dog."[10] This, however, is not a conflict in which the Commission should be involved. The Commission put it best in Docket No. R2006-1 saying, "[T]he Commission is mindful of the need to *strike a balance* between the needs of shippers and competitors."[11] The Commission should adopt a similar posture in the instant proceeding. In the absence of evidence that the Postal Service is or will be competing unfairly, the Commission should avoid establishing a requirement that the Postal Service must price its competitive products ever higher in a way that favors the Postal Service's competitors to the detriment of mailers. Rather, the Commission should allow the market to strike a balance between retail shippers and competitors.

### C. BASING THE APPROPRIATE MINIMUM SHARE OF COMPETITIVE PRODUCTS' CONTRIBUTION ON TOTAL REVENUE WOULD OVERSTATE THE APPROPRIATE MINIMUM SHARE.

In its initial Comments, UPS proposes an alternative benchmark for the minimum institutional contribution requirement which would be set to equal the revenue from competitive products as a percentage of total revenue. UPS Comments at 39. However, this proposed method ignores the fact that the share of total revenue from competitive products is not only a function of increasing competitive product revenue, but could also be due to the decline in revenue from market dominant products. Basing the appropriate share requirement on this type of method would overstate the competitive products' share because some of that share is due to the decline in market dominant revenue.

### D. A LARGER COMPETITIVE PRODUCT CONTRIBUTION WOULD NOT REDUCE THE MARKET DOMINANT PRODUCTS' RATE BURDEN.

UPS's argument that market dominant consumers are unfairly burdened if the competitive products do not recover what UPS believes is an appropriate share of institutional costs is misleading. Sidak at 1, 10. UPS fails to recognize that the market dominant rates, and thus postage paid by market dominant consumers, will not be

[10] Mark B. Solomon, *supra*, n 4.

[11] PRC Docket No. R2006-1, Opinion and Recommended Decision, February 26, 2007 at 387.

automatically lowered by an offset if competitive products are required to yield a higher share of institutional costs. UPS fails to mention that the Postal Service is no longer operating on a cost of service basis where recovery of costs by one customer reduces the burden on other customers. In fact, the appropriate share percentage regulation will have no impact on the rates for market dominant products which are governed by the price cap.

### E. INCREASING THE CONTRIBUTION REQUIREMENT WOULD NOT NECESSARILY REQUIRE THE POSTAL SERVICE TO RAISE RATES FOR PRODUCTS WHERE ITS RATES ARE BELOW THOSE OF ITS COMPETITORS.

UPS stated in another Commission proceeding, “Priority Mail, UPS Ground, and FedEx Ground have comparable characteristics, and these products are often viewed as comparable by Wall Street analysts, business journals, third party shipping services, and the Postal Service itself. UPS is not aware of any [of] its products being considered more directly comparable to Priority Mail.”[12] UPS Ground competes with Postal Service Priority Mail most heavily at the up to one pound weight range and in some zones for up to 2 and 3 pounds. In those few rates cells, Postal Service published rates are lower than its rivals’ published rates.[13] On the other hand, UPS’s published rates are in most cases substantially lower than the Postal Service’s rates for parcels heavier than one pound and heavier than many 3 and 4 pound parcels.[14] Raising the contribution requirement for competitive products would not necessarily provide UPS relief at its primary point of competition with the Postal Service in those few low weight categories where their competition is strongest. To meet a higher contribution requirement, the Postal Service may adjust its competitive rates as it sees fit, either among its other competitive products or in higher weight Priority Mail rate cells without necessarily raising its rates in the lighter weight categories.

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[12] Docket No.RM2016-2, UPS Response to CHIR No. 5, question 1c at 1-2.

[13] *See* UPS Domestic Ground Rate Schedule, 2017, at 68, https://www.ups.com/media/en/daily_rates.pdf; Postal Service Mail Classification Schedule, Priority Mail, Section 2110.6, January 22, 2017 at 246-248.

[14] *Id.* Compare Postal Service Priority Mail rates with UPS Ground rates.

**F. AN UPWARDLY-RATCHETING CONTRIBUTION REQUIREMENT PROPOSED BY UPS WOULD REQUIRE EVER HIGHER RATES TO PROVIDE A CUSHION FOR UNFORESEEN CIRCUMSTANCES.**

UPS asserts the appropriate share should be established at the three year average contribution level based on the competitive products' share of attributable costs from the years 2014-2016 at 29.4 percent. UPS Comments at 35. Regardless of the method used to calculate the benchmark contribution requirement, if the minimum contribution level is continually revised upward based upon the most recent contribution level, the required contribution will increase as competitive product profits increase to ever higher levels until they become, in effect, a ceiling. The Postal Service would have no relief from the benchmark requirement if the economy slows or if profits falter for any number of reasons, many of which may be beyond control of management. Out of an abundance of caution, the Postal Service would be forced to increase competitive product prices to return more contribution than the benchmark level to allow for a margin of safety to ensure it maintains its required level of contribution if demand falters. But consistently raising prices may, and very likely, will increase competitive product prices in the near future to a level higher than the market will bear and thus will soon reduce their revenue and contribution.

**G. THE POSTAL SERVICE'S RIVALS HAVE OTHER TRANSPORTATION BUSINESS SEGMENTS TO BOLSTER THEIR EFFORTS TO MEET POSTAL SERVICE COMPETITION.**

UPS suggests the Postal Service's other lines of business, *i.e*. market dominant products, allow it to recover less than a fair share of institutional costs from its competitive products. UPS apparently is concerned primarily about competition from the Postal Service's one pound and under rates. However, just as the Postal Service has letter mail as a line of business not open to its rivals, UPS and FedEx also have a line of business they could draw upon which offer a measure of economies of scale and increased efficiency not enjoyed by their rival. UPS and FedEx transport packages between 75 lbs. up to 150 lbs., a line of business where the Postal Service does not compete.[15] Moreover, FedEx has recently announced another line of business that could bolster its competitive efforts. It intends to launch a new service to compete with Amazon's fulfillment service by integrating backward through the supply chain to establish its own fulfillment service where it would handle the entire order fulfillment process, such as warehousing products, packaging, delivering and taking return orders. Neither of those lines of business is reasonably available to the Postal Service.

### H. A FAIRER MEASURE OF COMPETITIVE PRODUCT CONTRIBUTION IS THE PERCENTAGE OF ACTUAL INSTITUTIONAL COSTS RECOVERED BY COMPETITIVE PRODUCTS.

The share of institutional costs cited by UPS as contributed by the Postal Service's competitive products does not represent the true proportion of institutional costs actually recovered by competitive products vis a vis market dominant products. This is because the Postal Service does not recover all of its institutional costs in any year. Unless the percentage of actual institutional costs recovered is considered rather than booked institutional costs, competitive products appear to be recovering less than their actual share of institutional costs recovered; in effect, the entire burden of the Postal Service's annual loss is placed on competitive products and no burden is placed on market dominant products. Because of the shortfall due to the RHBF requirement, the Postal Service fell short in FY 2016 of recovering all of its institutional costs by $5,590.7 million.[16] Total institutional costs in FY 2016 were $36,353.5 million,[17] but actual recovered institutional costs were only $30,772.8 million.[18] Thus, while UPS would calculate that in FY 2016 competitive products recovered 16.5 percent of total

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[15] 2015 UPS Rate and Service Guide, Standard List Rats, Updated November 2, 3015, express and ground rate schedules at 43-71; Service Guide, fedex.com/service guide, updated October 6, 2015, express and ground rate schedules at 30-5 and 105-111.

[16] Docket No. ACR 2016, Library Reference USPS-FY16-1 at 3, total costs less total revenue, in millions: $77,121.1 - $71,530.4 = $5,590.7.

[17] *Id*. "All Other" costs, *i.e.* total costs less total attributable costs, in millions: $77,121.1 - $40,757.6 = $36,353.5.

[18] *Id*., total revenue less total attributable costs, in millions: $71,530 - $40,757.6 = $30,772.8.

institutional costs,[19] competitive products contributed 19.5 percent of the institutional costs actually recovered.[20] That percentage easily exceeded the target minimum of 17.5 percent that UPS proposes should be set for FY 2018, two years after the FY 2016 contribution level already reached. UPS Initial Comments at 37.

## I. MR. SIDAK'S DECLARATION PRESENTS CERTAIN ERRONEOUS ASSERTIONS AND CONCLUSIONS.

*Increasing the contribution requirement would not alter the Market dominant price cap.* First, Mr. Sidak has concluded the Commission's appropriate share "forces market-dominant products to bear a disproportionate amount of institutional costs …." Sidak at 1. In fact, the appropriate share requirement does not force anything on the market-dominant customers. He overlooks the fact that the mix of revenue between market dominant and competitive customers is not a zero sum game. Regardless of the amount of institutional costs recovered by competitive products, market dominant product rates are limited by the price cap. This limit has led to huge Postal Service losses while market dominant products have been set at their full price cap limit under the PAEA. Change in the appropriate share regulation would not alter the price cap requirement.

*Scale of operations versus profit maximization.* Second, Sidak states, "the Postal Service's incentive to underprice competitive products to increase the scale of its operations potentially places additional pressure on market-dominant revenues and on the Postal Service's finances." *Id.* Sidak appears uncertain of his underlying implication that the Postal Service actually does underprice its competitive products. He only presumes there is a potential for placing pressure on market dominant revenue. But this assertion rests on his assumption that, as a regulated concern, Postal Service

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[19] *Id.*, total competitive revenue less total competitive attributable costs divided by total institutional costs: $18,495.4 - $12,496.2/$36,363.4 = 16.5 percent. *See also* Docket No. ACR2016-1, United States Postal Service FY 2016 Annual Compliance Report at 90.

[20] *Id.,* total competitive revenue less total competitive attributable costs: $5,999.2/ $30,772.8 = 19.5 percent. *See also* Docket No. ACR2016-1, United States Postal Service FY 2016 Annual Compliance Report at 90.

management is incentivized to underprice its products in order to increase the scale of its operations.

To support his claim that management does, in fact, seek to expand its scale of operations, Sidak refers to some published articles, to only a portion of the Postal Service's management bonus structure, and to the continuing claim that the Postal Service prices its competitive products below cost, a theory recently rejected by the Commission.[21] Sidak at 11-14. Significantly, there has been no demonstration that the Postal Service is underpricing its competitive products or that the Postal Service is attempting to expand its scale of operations at its rival's expense with unfair pricing tactics. The Postal Service's packages volume growth has been partially generated by the recent shifts of market dominant products to the competitive product list. The growth has also been generated by an internet market expanding so quickly that peak growth has been difficult to meet by all participants. Growth has not been due to a rush to expand the scale of Postal Service operations to increase its market share. More importantly, Sidak's thesis that management of regulated companies is incentivized to increase the scale of operations, rather than profits, is not applicable to the Postal Service's competitive products. *Id.* at 1, 11-14. They are products which were deregulated specifically to allow the Postal Service to maximize profits on those products rather than to increase its scale of operations. In addition, due to the Postal Service's precarious finances, it does not have the luxury of trading scale for profits.

*Financial stability* Sidak asserts the Postal Service must recover additional revenue from competitive products to restore financial stability. *Id*. at 14-16. In fact, recovering some additional revenue from competitive products would not solve the Postal Service's financial difficulties. Significant relief from the retiree health benefit

[21] Docket No. RM2016-2, Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), September 9, 2016 (Order No. 3506) at 125.

fund payments is necessary to restore the Postal Service to financial health, not merely an increase in competitive product prices.[22]

## III. CONCLUSION

The Public Representative submits the foregoing comments for the Commission's consideration.

Respectfully submitted,

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[22] Sidak says that inefficient competitive product prices distort dynamic competition to the detriment of consumers. *Id*. at 1. It has not been shown that the Postal Service's pricing is inefficient or how raising the price of competitive products throughout the industry would aid consumers. Sidak seems to assume raising prices for Postal Service products alone would result in efficient prices throughout the industry without considering whether the prices of the Postal Service's rivals would also be raised or whether those prices are efficient. This is particularly uncertain where the published prices of UPS and FedEx for comparable products appear to be identical to the penny for each of hundreds of rate cells in the products where they compete most strongly with the Postal Service. *See* Docket No. RM2016-2, Public Representative Comments, January 27, 2016 at 45-46.